SIA

Foreign Activity

An Analysis of Foreign Participation in the U.S. Securities Markets
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The Times They Are A-Changin'

As noted in a recent issue of the *Foreign Activity Report,* new investment opportunities worldwide will increasingly vie with the U.S. for the available supply of capital. Moreover, we speculated that this could lead to a diminished supply of capital for the U.S.—capital which otherwise would finance the U.S. deficit, support capital investment, etc. In 1989, this was already becoming evident as Japanese inflows of $6.4 billion were at their lowest level since inflows of $3.1 billion in 1983.

Indeed, in 1Q90, despite a stable dollar, foreign investors were net sellers of U.S. securities for the first time since 3Q83. Net sales of U.S. securities totalled over $4 billion in 1Q90, compared to $800 million in 3Q83. In sharp contrast to 3Q83, when OPEC's net sales of treasuries resulted in a net outflow of capital, 1Q90 saw a broad-based pattern of selling by geographical area and type of security.

Foreign Net Activity in U.S. Securities
($Bils.)

	1Q90	*3Q83*
Equities	(3.3)	1.0
Treasuries	(6.5)	(1.9)
Corp. Bonds	3.4	0.3
U.S. Agencies	2.2	(0.2)
Total	(4.2)	(0.8)

While considerations outside of these new opportunities surely played a role in the foreign investors' posture, we believe this emphasizes that the U.S. can no longer count on an unending supply of foreign capital. Moreover, other countries which seek foreign capital, such as the LDCs, may have to move relatively more aggressively in the future to attract foreign capital.

Less Investment In U.S. Equities: A Cyclical Trend Towards Europe?

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. EQUITIES BY FOREIGN INVESTORS ($Mils.)

	FOURTH QUARTER 1989		*FIRST QUARTER 1990*		
	GROSS ACTIVITY	*NET PURCHASES*	*GROSS ACTIVITY*	*NET PURCHASES*	*% CHANGE IN GA 1Q90-4Q89*
EUROPE	**$50,995**	**($1,243)**	**$44,855**	**($1,317)**	**(12.0%)**
BELGIUM-LUXEMBOURG	3,826	306	3,823	209	(0.1%)
FRANCE	4,196	(816)	2,939	(305)	(30.0%)
GERMANY	3,207	(277)	3,105	149	(3.2%)
NETHERLANDS	1,899	183	1,588	(18)	(16.4%)
SWITZERLAND	9,687	(1,195)	7,634	(922)	(21.2%)
UNITED KINGDOM	25,416	440	22,793	(811)	(10.3%)
CANADA	**11,268**	**(736)**	**9,077**	**(253)**	**(19.6%)**
LATIN AMERICA & CARIBBEAN	**16,595**	**(353)**	**13,019**	**(497)**	**(21.5%)**
BERMUDA	3,671	(213)	3,018	(24)	(17.8%)
NETHERLANDS ANTILLES	5,085	(423)	4,275	(395)	(15.9%)
ASIA	**24,069**	**1,841**	**21,612**	**(1,080)**	**(10.2%)**
HONG KONG	2,285	(47)	2,590	4	13.3%
JAPAN	16,171	1,233	13,868	(702)	(14.2%)
OIL EXPORTING COUNTRIES	4,452	492	4,000	(358)	(10.2%)
TOTAL ALL COUNTRIES*	**$105,192**	**($412)**	**$90,571**	**($3,299)**	**(13.9%)**

Source: U.S. Treasury
* Total activity incorporates revised data; country activity does not incorporate revisions

Higher interest rates, a 4% price decrease in U.S. equities (7% decline in January alone), and opportunities elsewhere led foreign investors to make net sales of U.S. equities totalling $3.3 billion, the second largest selloff ever. Gross transactions totalled $90.6 billion, a 14% decrease from the previous quarter and well below 1989's quarterly average of $104 billion. Foreign investors have now pulled $3.7 billion out of the U.S. equity market in the last two quarters. Since the U.S. economic picture has not deteriorated significantly enough during this period to account for this decidedly negative posture, we believe the events in Europe are siphoning off equity capital previously invested in the U.S. While foreign investors will continue to invest in U.S. equity markets, we will not be surprised if it is more erratic than in the past.

The pullback was worldwide, as investors from Europe, Canada, Latin America and Asia sought non-U.S. investment alternatives. We note that all major geographical areas showed negative returns (local terms) during 1Q90, ranging from a small 0.4% decline in the Nordic countries to nearly 25% in Japan. European investors were the largest net sellers, with sales outpacing purchases by $1.3 billion. This marks the second straight quarter of European net sales; 4Q89 net sales totalled $1.2 billion.

Investors from the U.K. made net sales of over $800 million. Developments in Eastern Europe have certainly influenced the strategies of U.K. investors. According to the *Financial Times,* the U.K. is second among EC countries in the number of joint ventures entered in Poland and Hungary. Interest is also being diverted to EC countries. U.K. investors made net purchases of over $2 billion in German equities during 1Q90. Spain has also been a major beneficiary of U.K. investment: U.K. money managers were the largest investors in Spanish shares and property in 1989 (*Financial Times,* 6/25/90).

The Swiss made net sales of nearly $1 billion in 1Q90. These investors have now gone ten consecutive quarters without committing new monies, net, to U.S. equities. Aggregate net sales during this period were close to $9 billion. No ready explanation accounts for this divestment. Given the conservative nature of the Swiss investor, the October 19, 1987 crash almost certainly provided the initial reason for repatriating capital. In addition, changes in Swiss regulations have forced Swiss pension fund managers to increase domestic equity exposure from 5% to 7%. The uncertain economic environment after the crash may have prompted Swiss pension funds to raise cash levels by selling foreign equities.

Investors from France made net sales of over $300 million in 1Q90. Similar to investors from Switzerland, French investors seem to have shunned U.S. equities in the post-crash era. Ironically, starting in 2Q86 and up until the crash, French investors showed signs of becoming significant investors in the U.S. and made net purchases of $2.4 billion. With the crash as background, the pace of French deregulation, economic and political events in Europe, an explosion in the supply of French equity (in 1989 equity offerings totalled Ffr317 billion, over double 1988's Ffr157 billion), and one of the best performing economies in the EC, have given French investors good reason to concentrate on French and European investments.

Japanese investors, concerned over the rapid decline in the Tokyo market, made net sales of slightly over $700 million. This continues an erratic investment posture by Japanese investors in U.S. equities. Since the Yen/Dollar Agreement in 1985, Japanese investors had been avid purchasers of U.S. equities. During the period 4Q85 to 3Q88, these investors made net purchases in each quarter, totalling $20.7 billion. In the last year and a half, however, investment in U.S. equities has been much less predictable, with net sales occurring in three of the past six quarters.

The flow of capital to the U.S. in the mid- to late 1980's may have brought Japanese investors' holdings of U.S. equities to levels appropriate for portfolio diversification purposes. Combined with increased interest in direct investment, growing worldwide investment opportunities, and recent domestic events, these investors will continue to commit money to U.S. equities, but at a reduced level.

Foreign Investment In U.S. Treasuries: Greater Value Elsewhere

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. TREASURY NOTES AND BONDS BY FOREIGN INVESTORS
($Mils.)

	FOURTH QUARTER 1989		*FIRST QUARTER 1990*		
	GROSS ACTIVITY	*NET PURCHASES*	*GROSS ACTIVITY*	*NET PURCHASES*	*% CHANGE IN GA 1Q90-4Q89*
EUROPE	**$375,121**	**$4,557**	**$364,112**	**$1,048**	**(2.9%)**
GERMANY	11,850	3,538	12,629	981	6.6%
SWITZERLAND	10,803	(1,321)	7,245	(539)	(32.9%)
UNITED KINGDOM	268,536	4,156	264,905	1,473	(1.4%)
ASIA	**534,701**	**1,153**	**547,733**	**(2,385)**	**2.4%**
JAPAN	464,395	1,379	473,761	(3,941)	2.0%
"OTHER ASIA"	23,361	(2,557)	20,654	2,938	(11.6%)
NONMONETARY INT'L & REGIONAL ORGANIZATIONS	**49,182**	**2,648**	**45,787**	**(809)**	**(6.9%)**
TOTAL ALL COUNTRIES*	**$1,044,624**	**$7,206**	**$1,023,489**	**($6,527)**	**(2.0%)**

Source: U.S. Treasury
* Total activity incorporates revised data; country activity does not incorporate revisions

After record net purchases of near $55 billion in 1989, foreign investment in U.S. treasuries tumbled in 1Q90. Indeed, foreign investors made net sales of U.S. treasuries, $6.5 billion, for the first time since net sales of $1.4 billion were made in 3Q88. Central banks made net sales of close to $4.9 billion in 1Q90, while private investors accounted for net divestitures of $1.6 billion. Among the largest net sellers of U.S. governments were Canada, Japan, the Netherlands, Singapore and Australia.

The Relative Attractiveness Of U.S. Bonds Falls As Yield Spreads Become Increasingly Thin

(Basis Point Difference)

	Japan	*W. Germany*
'86	274	146
'87	417	204
'88	457	227
1Q'89	**466**	**233**
2Q'89	378	175
3Q'89	310	118
4Q'89	224	48
1Q'90	**145**	**-2**

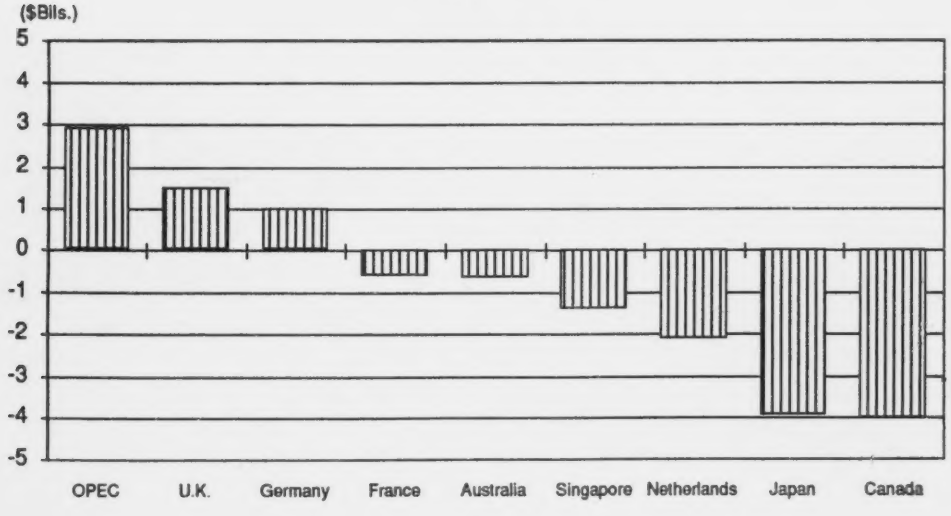
Source: Bank For International Settlements

First, after trending downward in 1989, rising U.S. interest rates in 1Q90, and uneasiness about possible rate hikes made these securities unattractive. In contrast, since the beginning of 1989, yields on foreign governments had been rising faster, closing the yield spread between U.S. governments and foreign governments and making foreign bonds more attractive. Moreover, this has occurred despite a U.S. inflation rate which is higher than many European countries. For instance, German governments actually yielded 2 basis points more than U.S. governments, the first time yields on German governments exceeded U.S. rates in 14 years. Yields on Japanese governments closed to less than 150 basis points, compared to spreads of over 450 basis points in late 1988.

Canadian investors took the most decidedly negative posture, with net sales of over $4 billion. A political dispute over the Meech Lake Accord, as well as a rise in Canadian yields, which increased the spread over U.S. treasuries to 200 basis points, gave ample reason to invest at home. Net sales of $3.9 billion from Japanese investors reflected activity by the Bank of Japan to counter the strengthening dollar and private investors' concern over the turmoil at home.

OPEC continued their resurgence in the U.S. treasury market by making net purchases of $2.9 billion. In that many countries seem to be lessening their exposure to the U.S. market, OPEC's return to the U.S. market comes at a welcome time.

Foreign Net Activity in U.S. Treasuries in 1Q90:
Going, Going, Gone



U.S. Investment In Foreign Equities: EC Bound

U.S. investment in foreign equities presented a mixed picture in 1Q90. Gross

transactions posted a modest 8.1% gain, to a record $72.8 billion. On the other hand, net purchases plunged to $355 million, well short of the $3.4 billion quarterly average in 1989. Investment in the EC was strong, totalling $1.4 billion. In addition, U.S. investors took a particularly global approach in 1Q90, making record net purchases in Australia and Mexico.

GROSS TRANSACTIONS IN AND NET PURCHASES OF FOREIGN STOCKS BY U.S. INVESTORS
($Mils.)

	FOURTH QUARTER 1989		*FIRST QUARTER 1990*		
	GROSS ACTIVITY	*NET PURCHASES*	*GROSS ACTIVITY*	*NET PURCHASES*	*% CHANGE IN GA 1Q90-4Q89*
EUROPE	**$35,376**	**$2,484**	**$42,923**	**$505**	**21.3%**
EUROPEAN COMMUNITY	*$32,287*	*$4,911*	*$38,549*	*$1,464*	*19.4%*
BELGIUM/LUXEMBOURG	593	77	595	67	0.3%
DENMARK	78	26	251	57	221.8%
FRANCE	2,150	474	3,464	(706)	61.1%
GERMANY	1,897	585	3,775	903	99.0%
GREECE	8	4	10	4	25.0%
IRELAND	119	69	133	75	11.8%
ITALY	1,084	(18)	3,507	931	223.5%
NETHERLANDS	1,754	300	1,982	100	13.0%
PORTUGAL	41	37	14	10	(65.9%)
SPAIN	1,131	115	906	116	(19.9%)
UNITED KINGDOM	23,432	3,242	23,921	(89)	2.1%
SWITZERLAND	2,292	532	3,329	(963)	45.2%
CANADA	**2,815**	**511**	**2,879**	**461**	**2.3%**
ASIA	**20,693**	**869**	**20,647**	**(1,235)**	**(0.2%)**
JAPAN	17,696	1,084	17,705	(1,349)	0.1%
OTHER	**2,981**	**291**	**6,350**	**624**	**113.0%**
TOTAL ALL COUNTRIES*	**$67,354**	**$4,233**	**$72,799**	**$355**	**8.1%**

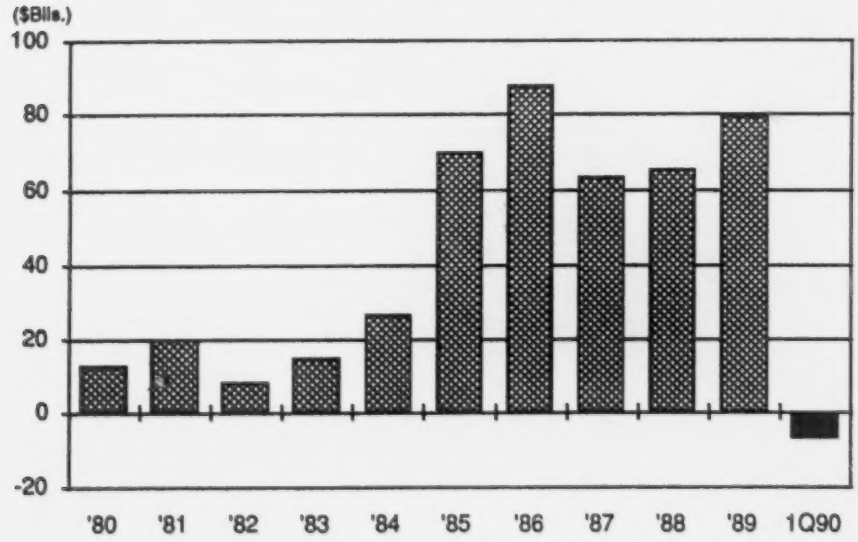
Source: U.S. Treasury
* Total activity incorporates revised data; country activity does not incorporate revisions

Investment in EC countries attracted the majority of U.S. interest. U.S. commitments to Italy and Germany totalled $931 million and $903 million, respectively. (See *Foreign Activity Report,* Vol. XIII, No. IV for details.) Indeed, outside of net sales of $700 million in France and less than $100 million in the U.K., net purchases were made in all other EC countries. U.S. Department of Commerce data underscores the growing U.S. commitment to Europe. Holdings of European equities climbed by nearly 60%, to $59.8 billion in 1989. Net purchases in 1Q90 indicate a readiness to increase exposure to Europe.

The main event driving international capital flows continues to be the increasing demand for capital. As *both* U.S. and non-U.S. investors look for new investments, the supply of capital available for the U.S. is diminishing. During the mid- to late 1980s, net capital inflows (foreign portfolio investment in the U.S. minus U.S. foreign portfolio

investment) averaged about $73 billion per year. In glaring contrast, the U.S. actually experienced net portfolio outflows of over $7 billion in 1Q90.

Net Portfolio Investment In The U.S.



As other countries have been attracting direct investment, the U.S. is now also competing for portfolio investment. Given the realities of a rapidly changing economic picture, foreign portfolio investment in the U.S. will be more erratic, and come at a greater cost than in the past.

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GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. CORPORATE BONDS BY FOREIGN INVESTORS
($Mils.)

	FOURTH QUARTER 1989		*FIRST QUARTER 1990*		*% CHANGE IN GA 1Q90-4Q89*
	GROSS ACTIVITY	*NET PURCHASES*	*GROSS ACTIVITY*	*NET PURCHASES*	
EUROPE	**$18,041**	**$3,143**	**$14,478**	**$2,454**	**(19.7%)**
BELGIUM-LUXEMBOURG	979	(503)	695	(273)	(29.0%)
FRANCE	780	(74)	537	91	(31.2%)
GERMANY	932	32	970	(382)	4.1%
SWITZERLAND	1,189	(287)	719	282	(39.5%)
UNITED KINGDOM	12,566	3,572	10,251	2,661	(18.4%)
ASIA	**8,318**	**2,532**	**4,998**	**172**	**(39.9%)**
JAPAN	6,495	1,897	3,720	(84)	(42.7%)
"OTHER ASIA"	813	301	623	215	(23.4%)
TOTAL ALL COUNTRIES*	**$30,599**	**$6,737**	**$23,550**	**$3,402**	**(23.0%)**

Source: U.S. Treasury
* Total activity incorporates revised data; country activity does not incorporate revisions